

**TESTIMONY CONCERNING
THE COMMISSION'S EFFORTS
TO STRENGTHEN THE ACCOUNTING PROFESSION**

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Committee on Financial Services

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Chairman Oxley, Ranking Member Frank, and members of the Committee:

Thank you for inviting me to testify today concerning the SEC's efforts to strengthen the accounting profession. Fourteen months ago, Congress showed tremendous leadership in passing the Sarbanes-Oxley Act aimed at reforming corporate governance and restoring investor confidence in our securities markets. The centerpiece of this legislation is the Public Company Accounting Oversight Board, or PCAOB. I want to assure you that the Commission is dedicated to working with the PCAOB to accomplish the goals of that legislation – including restoring the confidence of investors in the integrity of the audit process and in the reliability of the financial information that fuels our Nation's securities markets.

In a matter of months, the joint efforts of the Commission and PCAOB have turned what was an outline on paper into an energetic organization that is guided by a hard-working, entrepreneurial staff. The Board is absolutely vital to our markets going forward, and it has already launched a number of important measures, such as accepting

accounting firm registrations, collecting the funds authorized by Sarbanes-Oxley, initiating inspections of accounting firms, developing rules for its disciplinary programs, and writing new auditing standards.

We at the Commission were extremely pleased when Bill McDonough, also testifying before you today, assumed the Chairmanship of the PCAOB in June. Even before that, however, the other four Board members – Kayla Gillan, Dan Goelzer, Bill Gradison, and the Acting Chairman Charley Niemeier – worked hard to make significant progress in developing the Board’s operational infrastructure. As a result of their efforts, the Commission certified in April, as required by law, that the PCAOB possessed the capacity to meet the requirements of the Sarbanes-Oxley Act. Under Mr. McDonough’s leadership, we expect the Board to implement reforms that will restore confidence in the integrity of the financial information that investors use every day to make investment decisions.

While the PCAOB operates separate and distinct from the Commission, the Act vests the Commission with oversight authority and responsibility over the PCAOB. In addition to appointing Board members, the Commission must approve all of the Board’s rules and professional standards before they may become effective, must approve the Board’s annual budget and support fee, acts as an appellate authority for PCAOB disciplinary actions and disputes related to PCAOB inspection reports, and may assign additional tasks to the Board as appropriate. As part of its oversight, the Commission

also has the authority to inspect the PCAOB in much the same way that it inspects the securities exchanges and the National Association of Securities Dealers.

I am pleased to report on the Commission's active role in helping the PCAOB meet its mandate. To date, the Commission has published three notices of PCAOB rulemaking, issued six Orders related to the PCAOB's financial matters and rules, issued an affiliated Order concerning the Financial Accounting Standards Board's support fee, published a Commission Notice regarding auditors of broker-dealers' financial statements registering with the PCAOB, provided the PCAOB with three advances to fund its initial operations, and has under consideration for Commission approval two additional PCAOB rules. Many of these efforts are described below.

In the startup days of the PCAOB, before the Commission recognized it as fully operational, Commission staff had formal weekly meetings with the PCAOB and its staff, and the two staffs were in almost daily contact on matters related to the PCAOB's organization, staffing, rulemaking, and budget. Since then, frequent consultations have continued on the Board's numerous projects. We expect the close working relationship between the two organizations to continue as the PCAOB begins to expand its consideration of new and improved professional standards, to implement its inspection process, and to begin its disciplinary program.

Some of the more significant events and milestones include the following.

Interim Funding – Since January, the Commission has approved three separate advances of funds from the U.S. Treasury to the PCAOB totaling \$20,342,000. These funds have been used to hire staff, rent office space, buy office and computer equipment, finance the development of information technologies, and begin operation of the PCAOB’s standard setting, registration and inspection programs. The PCAOB currently anticipates repaying these advances by September 30 with funds collected from public companies and investment companies, as provided under the Act.

PCAOB Readiness – Within the time frame specified in the Act, the Commission determined on April 25, 2003, that the PCAOB is organized appropriately and has the capacity to carry out the requirements of the Sarbanes-Oxley Act and to enforce compliance with that Act. The Commission did so after considering the status of the PCAOB’s programs, including, among other things, its development of a registration system for accounting firms, the adoption of interim/transitional professional standards, its plans for inspecting and disciplining accounting firms, the development of its budget and “support fees” to be assessed on public companies, and the commencement of hiring of professional staff.

Professional Standards – On April 25, the Commission also approved the PCAOB’s adoption, as interim PCAOB standards, of the American Institute of Certified Public Accountants’ auditing, quality control, ethics and independence standards, and

certain of the AICPA's SEC Practice Section membership requirements.¹ Adoption of these standards ensured continuity in the standards that govern audits of public companies. At the time that the PCAOB adopted these interim standards, it announced its intention to review each standard to determine whether it should be retained, repealed or modified. The PCAOB also announced that it would convene an advisory body to assist it in reviewing and revising those standards and in future standard setting.

As mandated by the Act, the PCAOB currently is writing a new auditing standard related to auditors' testing and reporting on companies' internal controls over financial reporting. This standard will complement the Commission's rule requiring managements to report the effectiveness of their internal controls. The Commission's Deputy Chief Accountant and the Director of the Commission's Division of Corporation Finance recently participated in a PCAOB roundtable on the development of that standard. We expect the PCAOB to publish a draft standard for public comment in the near future. This standard, like all PCAOB rules, is subject to Commission approval before it becomes effective.

Registration of Accounting Firms – Under the Act, only accounting firms registered with the PCAOB may issue or participate significantly in the issuance of any audit report with respect to any issuers' financial statements. On July 16, 2003, the Commission approved the PCAOB registration form and PCAOB rules that require

¹ As permitted under the Act, the interim rules were adopted and approved by the Commission without performing the rulemaking procedures set forth in section 19(b) of the Securities Exchange Act of 1934 that generally apply to the PCAOB.

registration by all domestic and foreign firms that prepare or substantially assist in preparing audit reports filed with the Commission.

Prior to its adoption of these rules, the PCAOB held a roundtable, attended by Commissioners and staff, to solicit information regarding the implications of registration on foreign accounting firms. After consideration of the information provided at the roundtable and in other discussions with foreign regulators and accounting firms, the PCAOB made significant accommodations in its registration system for foreign accounting firms. These accommodations include providing a mechanism to ensure that foreign firms are not asked to violate laws in their home country in order to register with the PCAOB, narrowing the scope of the information provided to the PCAOB, and extending the deadline for foreign firms to register.

Bylaws – On July 23, 2003, the Commission approved the PCAOB’s bylaws. The bylaws establish procedures for the business operation and administration of the PCAOB, and are intended to facilitate fulfillment of the PCAOB’s obligations under the Act.

Annual Budget and Support Fee – Under the Act, the Commission is required to approve the PCAOB’s budget and support fee. After close examination, we approved the PCAOB’s first fiscal-year budget and support fee on August 1, 2003. Major items in the budget are information technology (including the development of its registration and billing and collection systems), salaries and benefits, and rent. The aggregate support

fee, which is allocated among and payable by issuers, generally equals recoverable budget expenses minus registration and annual fees paid by accounting firms.

Rules Related to Support Fees – Also on August 1, we approved PCAOB rules that prescribe the formula for allocating the support fee among issuers and the collection of those fees by the PCAOB. Under the formula, fees are paid by public companies with an average monthly United States equity market capitalization in excess of \$25 million and by investment companies with an average monthly U.S. equity market capitalization (or net asset values) greater than \$250 million. As required by the Act, the amount each company pays varies based on the company's market capitalization. The FASB is using the same formula to allocate its support fee among issuers, and the PCAOB is collecting the FASB's support fees as well as its own.

Auditors of Broker-Dealers' Financial Statements – Every broker-dealer registered with the Commission must file certified financial statements with the Commission annually. Although the Act has a deadline for auditors of issuers' financial statements to register with the PCAOB, there is no such deadline for auditors of broker-dealers. On August 4, 2003, the Commission issued a Notice stating that the registration requirements and procedures related to auditors of non-public broker-dealers still are being considered and delaying required registration until the earlier of January 1, 2005, or the adoption of applicable rules.

Ethics Code – As the body charged with maintaining the integrity of the accounting profession, the PCAOB and its staff must adhere to high ethical standards in fulfilling their duties under the Act. The PCAOB has adopted a code of conduct for its members and staff and submitted that code to the Commission for approval. The code addresses, among other things, financial and personal conflicts of interest, protection of non-public information, acceptance of gifts, outside activities, waivers of the code, restrictions on seeking other employment, and post-PCAOB employment. The Commission currently is reviewing the code prior to publishing it for public comment.

Inspection and Disciplinary Programs – The PCAOB’s inspection program will involve reviewing accounting firms’ quality controls and audit and business practices to assess each firm’s compliance with the Act, Commission rules, PCAOB rules, professional standards, and the firm’s own quality control policies. At the conclusion of each inspection, the PCAOB will report its findings to the Commission, state boards of accountancy and, except for certain confidential information and corrected internal control deficiencies, the public. Disputes regarding assessments contained in the report or whether potential defects in the firm’s quality control system have been corrected satisfactorily may be appealed to the Commission.

The PCAOB staff has begun limited inspections of the four largest accounting firms, initially focusing on matters that would not be reviewed under the AICPA’s peer review system. As the PCAOB hires more staff, it will expand the scope of its inspections.

The PCAOB disciplinary program will involve sanctioning accounting firms and professionals for not complying with the Act, PCAOB rules, Commission rules, or professional standards. The PCAOB currently is developing rules related to its investigations and adjudications. We look forward to establishing an effective working relationship with the PCAOB to sanction auditors who fail to fulfill their obligations to conduct diligent and independent audits and to report honestly to investors.

The PCAOB is conducting a thoughtful analysis of the nature of its oversight of foreign accounting firms that audit the financial statements of U.S. public companies and is discussing with foreign regulators ways to accomplish the inspection and disciplinary goals of the Act without subjecting foreign firms to unnecessary burdens or conflicting requirements. The Commission has encouraged the PCAOB to continue in these efforts.

In conclusion, I believe that the PCAOB is absolutely vital to the integrity of our Nation's security markets, and I am especially gratified that Bill McDonough is leading the Board's efforts. We should all realize, however, that the PCAOB alone cannot restore investor confidence in the integrity of the accounting profession. If these efforts are to be successful, each accountant, from the CEO of the accounting firm to its most recently hired employee, must demonstrate a willingness to place the interests of investors above all else. Remaining independent and "telling it like it is" is fundamental. Any accounting firm that uses the formation and work of the PCAOB as opportunities to improve the quality of its audit practice, to reassess and heighten its independence from

audit clients, and to renew its commitment to protecting the interests of investors, will be better and more effectively run and have more credible reports. For others, I assure you that the Commission and PCAOB will not hesitate to use all of the tools available under the Act and in other securities laws.

Thank you again for inviting me to testify.